Supreme Court of the United States

October Term, 1960

No.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE FOURTH CIRCUIT

INDEX.

	Page
CITATION TO OPINIONS BELOW	1
JURISDICTION	1
QUESTION PRESENTED	2
STATUTE INVOLVED	2
STATEMENT OF THE CASE	3
ARGUMENT FOR GRANTING OF THE WRIT	9
CONCLUSION	11
APPENDIX (OPINION OF THE COURT OF APPEALS FOR THE FOURTH CIRCUIT)	13

STATUTES CITED.

	Page
Internal Revenue Code of 1939, Section 23(a)(1)(A), 26 U. S. C. 1952 ed., Sec. 23	2, 9
28 U. S. C. 1254(1)	1, 2

IN THE

Supreme Court of the United States.

No.

OCTOBER TERM, 1960.

WEST VIRGINIA NORTHERN RAILROAD COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

Citation to Opinions Below.

The Memorandum Findings of Fact and Opinion of the Tax Court of the United States (Transcript, pages 1-9) are not officially reported, but are unofficially reported by Commerce Clearing House at 18 T. C. M. 975 and by Prentice Hall at 1959 P-H T. C. Memo Dec. ¶ 59,204.

The Opinion of the United States Court of Appeals for the Fourth Circuit (Transcript, pages 23-28) has not as yet been officially reported, but has been reported unofficially by Commerce Clearing House at 60-2 U. S. T. C. ¶ 9702 and by Prentice Hall at 6 A. F. T. R. 2d 5557.

Jurisdiction.

The Judgment of the Court of Appeals was filed and entered September 19, 1960 and its Order Denying Petition for Rehearing was filed and entered January 10, 1961.

Jurisdiction is conferred upon this Court by 28 U. S. C., Section 1254(1).

"Sec. 1254. Courts of Appeals; certiorari; appeal; certified questions.

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree; * * *".

Question Presented.

The sole question involved is the right of a railroad, in computing its income taxes, to deduct reasonable rentals actually paid under contract for the use of the two locomotives which supplied the railroad's only motive power, as ordinary and necessary business expenses.

Statute Involved.

The statutory basis for the allowance of the deductions claimed by the Petitioner is to be found in Section 23(a)-(1)(A), Internal Revenue Code of 1939, 26 U. S. C. 1952 ed., Sec. 23.

"Sec. 23. Deductions From Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses—

"(1) Trade or business expenses—

"(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. * * *"

Statement of the Case.

This proceeding involves Corporation Income Taxes for the calendar years 1951, 1952 and 1953 in the amounts of $11,355.42, $20,035.93 and $13,718.66 respectively.

The facts were substantially stipulated by the parties and are as follows:

West Virginia Northern Railroad Company, the Petitioner in this proceeding, is a corporation organized in 1883 with its principal place of business at Kingwood, West Virginia. It has consistently kept its books and prepared its income tax returns on a calendar year basis and employed an accrual method of accounting. Its tax returns for the years here involved were filed with the Office of the District Director of Internal Revenue at Parkersburg, West Virginia. Petitioner's business at all times here involved consisted of the operation of a railroad over 11 miles of track between the towns of Kingwood and Tunnelton, West Virginia, which line was a feeder road for the Baltimore and Ohio Railroad.

On June 14, 1946, four of the corporation's five stockholders were the owners of two diesel locomotives which they leased to the Petitioner on that date for a 5 year term under a written agreement of lease requiring rental payments monthly computed at the rate of 7½¢ per net ton of freight hauled by the Petitioner over its tracks. Under the lease agreement the Petitioner was required at its own expense to maintain the locomotives in good condition "wear and tear excepted" and at the end of 5 years to deliver them back to the lessors in good condition "damage by the elements excepted."

On December 30, 1950, the lessors each owned 100 shares of the Petitioner's outstanding capital stock. The only other stock outstanding consisted of 600 shares all of which were owned by James Jenkins, the father of the four lessors. On that date the 5 stockholders entered into a written agreement with the Preston Coal Company, a Missouri

Corporation, under which they granted to that corporation an option, exercisable on or before July 1, 1951, to purchase all of their stock in Petitioner for the sum of $500,000 provided the Preston Coal Company should simultaneously exercise an option independently acquired by it on the same day from the stockholders to lease or purchase approximately 25,000 acres of coal properties owned by the stockholders and located in Preston County, West Virginia.

In the stock option agreement it was provided that between December 30, 1950 and July 1, 1951, there should be no adverse changes in the balance sheet of the Petitioner, no changes in its capital structure, and that no extraordinary business should be transacted by it. It was further provided that, in the event the option should be exercised, the Preston Coal Company (or its assignee) would be required to agree to an extension of the diesel locomotive lease for a further term of 25 years provided certain minor amendments were made to the lease agreement. It was further provided that it would be agreed upon the expiration of the 25 year renewal period the Petitioner would be required to purchase the locomotives at their then fair market value.

On March 19, 1951, the Preston Coal Company assigned to Ralph R. Lewis all of its right, title and interest in and under both of the aforementioned option agreements. On or before July 1, 1951, Lewis notified the Jenkins family of his intention to exercise the options contained in the two option agreements of December 30, 1950.

Thereafter James Jenkins advised Lewis's attorney that he was greatly disturbed about the provisions of the stock option agreement because the Jenkins family did not have enough security under its terms. He threatened to refuse to carry out the agreement, stating that he would rather stand a loss than carry out an agreement which would give him and his children no protection. One of the points to which Jenkins was referring was that, although the stock was to be paid for in installments over a period of

15 years, with only $50,000 required to be paid down originally, the stock was to be turned over to Lewis in the first instance without any security lien. Furthermore, although the option agreement called for installment payments, it did not provide that the buyer should give the sellers any note for the unpaid balance. Furthermore, there was nothing in the agreement to prohibit the buyer from distributing all of the corporation's surplus to himself even though the stock had not yet been paid in full.

Due to the time consumed by conferences between the parties, they failed to consummate the transactions within the time limit set forth in the December 30, 1950, option agreements, but the time was extended by mutual agreement of the parties.

Lewis's attorney was sympathetic to some of the Jenkins' concerns, and he agreed to see that they had reasonable protection. He agreed that a note should be given and that the stock certificates should be pledged as collateral security for payment of the note. He also agreed to permit the Jenkins family to designate two of the five members of the Railroad's board of directors so long as the note had not yet been paid in full. In addition, and at their insistence, he agreed that there would be no increases in the salaries to be paid to the officers of the corporation and no dividends payable to the purchaser unless paid out of income earned after the sale of the stock. In addition, James Jenkins asked Lewis's attorney if he would agree that the rental to be paid by the corporation for the two diesel locomotives should be fixed at 12½¢ rather than at the 7½¢ rate contemplated in the option agreement and that the term of the lease be 15 years, without any right of cancellation on the part of the railroad except by purchasing the engines for $387,500.00 cash. Lewis's attorney refused to accede to this change because of the provision in the original option agreement which clearly contemplated that the 2 engines would be available to the corporation for 25 years at a rental of only 7½¢ per ton of freight hauled,

and the further provision contained therein to the effect that the financial condition of the company should not at settlement be materially worse than at the time the option agreement was executed in 1950;

Lewis's attorney advised the Jenkins family that such an increase in the rental charge would necessarily reduce the value of the corporation's stock and that the price to be paid by his client for the stock would, therefore, have to be reduced in a corresponding amount if any increase in the rental charge for the diesels was to be made; otherwise Lewis could not be required to pay the option price for the stock. The Jenkins family said that they wanted the rental rate increased and would agree to the corresponding reduction in the purchase price of the stock.

These points having been finally agreed upon, the parties on September 24, 1951, embodied them in several amendatory agreements, together with certain other amendments pertaining to the lease of the coal lands. Under the amendatory agreements the Railroad was not to be required to purchase the two locomotives at the termination of the 15 year period as had been the case under the original option agreement; but instead could turn them back to the owners.

These amendatory agreements further provided that the amount due by Lewis on the note given to the Jenkins family to cover the price of the stock to be purchased should be reduced from time to time by the amount of all locomotive rentals payable by the Railroad in excess of the original 7½¢ per ton rate.

It was further provided that at the time of settlement the Jenkins family would loan to Lewis the sum of $90,000.00 to be used by him to make the $50,000.00 initial payment required on the stock purchase, a $20,000 initial payment required on the lease of the coal properties and $20,000.00 to pay the costs and expenses of bankers with whom Lewis had been dealing in the transaction. It was agreed that this $90,000.00 should be included in the

same note with the $450,000.00 balance of the purchase price of the stock so that the total amount of indebtedness to be evidenced by the note of Lewis to the Jenkinses would be $540,000.00. The note was to bear interest at the rate of two per cent (2%) per annum and call for annual payments of $34,666.66 for 15 years and, in addition, for a $20,000.00 payment 18 months after the note was executed.

On the same day, the Board of Directors of the Railroad (consisting of the members of the Jenkins family) met and adopted on behalf of the corporation the new locomotive lease agreement calling for rental payments monthly at the rate of 12½¢ per ton of freight hauled over the line for a period of 15 years. Because the old lease had expired by its terms on June 13, 1951, while the parties were negotiating, the new lease was made effective retroactive to June 14, 1951.

The amount of additional rental for the two locomotives for the period from June 14, 1951 to September 24, 1951, at the 12½¢ rate as compared to the old 7½¢ rate was $9,953.75.

Settlement was then held and Lewis gave his note, dated September 24, 1951, in the amount of $540,000.00 to the Jenkinses.

Each month, thereafter, a statement of the number of tons of coal shipped over the Railroad was prepared and sent to the Jenkins family, showing the total rental payment due and specifying the amount thereof in excess of the old 7½¢ rate by which Lewis's note was to be reduced. The rental was paid monthly by the Railroad corporation at the same time. At the request of the 4 members of the Jenkins family who were the owners of the two locomotives, the rental was paid each month by the issuance of 5 checks, each for exactly ⅕ of the monthly rental, the fifth check being made payable to James Jenkins, the father.

The rentals payable under the locomotive lease for the years 1950-1953, inclusive were:

1950	7½¢ rate	$73,021.00
1951 prior to 6/14	7½¢ rate	$21,439.72
1951 after 6/13	12½¢ rate	$49,956.00
1952	12½¢ rate	$91,019.75
1953	12½¢ rate	$73,976.15

Under the September 24, 1951, agreement the following portions of the above rentals were required to be, and were in fact, applied in reduction of the installments due on the $540,000.00 note:

1951—$19,982.40
1952—$36,407.94
1953—$29,590.43

All rentals payable were in fact paid as above set forth monthly as soon as the amounts could be determined from the Railroad's books. The two diesel locomotives were the sole locomotive power used by the petitioner in its operations during the taxable years here involved.

In the annual reports which the Railroad filed with the Interstate Commerce Commission for the years here involved it reported the entire amount of locomotive rentals at the 12½¢ rate as "Rent for locomotives." It did likewise in its corporate income tax returns for those years.

The negotiations between the parties were carried on at arm's length. (This conclusion of fact is amply supported by the testimony of W. B. Saul, the only witness whose testimony was heard.)

The Respondent does not challenge the reasonableness of the 12½¢ rentals. On the contrary, he concedes that there is no issue of reasonableness here.

The amounts claimed as deductions for locomotive rentals during the taxable years here involved were in fact expenses of the taxpayer accrued during those years for the rental of its two locomotives and, as such, constituted ordinary and necessary business expenses.

That portion of the rental payments attributable to the 5¢ increase was disallowed by the respondent as an in-

come tax deduction. A petition for review of the respondent's action was timely filed with the Tax Court of the United States.

A Memorandum Opinion (T. C. Memo. 1959-204), sustaining the Respondent's position was filed by the Tax Court October 28, 1959. Decision for the Respondent pursuant thereto was entered by the Tax Court October 30, 1959.

A Petition for Review of that decision by the United States Court of Appeals for the Fourth Circuit was filed January 29, 1960.

An Opinion sustaining the decision of the Tax Court was filed by the Court of Appeals September 19, 1960, and the Judgment of that Court was filed the same day.

A Petition for Rehearing (Transcript, pages 30-34) was filed by Petitioner October 18, 1960 with the Court of Appeals. On January 10, 1961, the Court of Appeals filed its "Order Denying Petition for Rehearing" (Transcript, page 35).

Argument for Granting of the Writ.

The decision of the Court of Appeals sustaining the decision of the Tax Court should be reviewed and reversed by this Honorable Court, since it decides a federal question in direct conflict with the clear and unambiguous language of a federal statute. Section 23(a)(1)(A) of the Internal Revenue Code of 1939, set forth above, states that "In computing net income *there shall be allowed as deductions* * * * the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * *rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.*" (Emphasis supplied.)

The statute does not say that the Respondent may allow or disallow deductions for rental payments in his discretion. If the expenses of a taxpayer are in fact rentals, constituting ordinary and necessary business expenses, then the statute requires that they shall be allowed as deductions in computing the net income of the taxpayer. Of course, the taxpayer cannot convert nondeductible items into deductible items by calling them "rent" when they are not rent in fact, nor can he properly deduct excessive amounts merely by disguising some other form of nondeductible payments as rents. *But the amounts paid by the West Virginia Northern Railway Company for the lease of its only two locomotives are conceded to have been reasonable*, and nowhere is it suggested that they were not rental payments. Under these circumstances it is submitted that the taxpayer was and is entitled to the deductions claimed as a matter of law.

The decision appealed from countenances the arbitrary action of the Commissioner of Internal Revenue in deliberately withholding a right prescribed by a federal statute. Such action is in conflict with the law and is of great importance not only to the Petitioner, but to numerous taxpayers whose reliance on statutory language is jeopardized by judicial approval of arbitrary administrative departures from statutory rules.

The Court of Appeals indicates that substance rather than form must prevail; and with this Petitioner agrees heartily. It is submitted, however, that the Court was misled by the fact that the rental payments in question served a secondary purpose in measuring the price ultimately to be paid for the railroad. The fact that the volume of freight hauled by the locomotives was used as a formula for computing the purchase price seems to have disturbed the Court. Thus, when the purchase price was reduced 5¢ for each 5¢ increment of rent paid, the Court speaks of the rents as "a device for the payment of an obligation of Lewis," and consequently approves of disallowing the deduction for rent.

There is nothing mysterious about crediting the 5¢ increments against the purchase price. When the sale of the railroad was contemplated, the buyers were willing to pay a certain price for the entire package, including the right to use of the locomotives at 7½¢ per ton of freight hauled for 25 years. *They were naturally unwilling to pay the same price when the sellers raised the locomotive rent to 12½¢ and shortened the term of the lessee to 15 years.* The reduction of the amount they were then willing to pay was tied directly to the future use of the locomotives.

None of this changed the basic fact that the 12½¢ rent continued to be rent for essential equipment at a reasonable rate, clearly deductible under the statute.

Conclusion.

For the foregoing reasons, this petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit should be granted.

Respectfully submitted,

ALLEN S. OLMSTED, 2ND,
Attorney for Petitioner.

APPENDIX.

Opinion of the United States Court of Appeals for the Fourth Circuit.

(Caption omitted.)

SOPER, Circuit Judge: In this case review of the decision of the Tax Court [CCH Dec. 23,819(M)] is sought, wherein the court upheld the determination of the Commissioner of Internal Revenue of deficiencies in the income tax returns of West Virginia Northern Railroad Company for the years 1951, 1952, and 1953 in the respective amounts of $11,355.42, $20,035.93, and $13,718.66.

The taxpayer railroad company operates eleven miles of track between Kingwood and Tunnelton, West Virginia, as a feeder of the B. & O. Railroad Company. The stock of the corporation, amounting to 1,000 shares, was owned in 1951 and prior years by James Jenkins and his four children, 600 shares by him and 100 shares each by a son and three daughters. The Jenkins family also owned two diesel locomotives which, on June 14, 1946, they had leased to the railroad for five years at a haulage rental of 7½ cents per ton. These locomotives furnished the sole motive power of the railroad. The family also owned 2,500 acres of coal land in Preston County, West Virginia.

On December 30, 1950, the Jenkins family granted two options to the Preston Coal Company exercisable on or before July 1, 1951. The first option provided that the coal company might purchase all of the stock of the railroad company for $500,000 of which $50,000 should be paid in cash and the balance in fifteen annual instalments. The option also provided that in the event of exercise the purchaser would take a twenty-five year extension of the locomotives lease at the 7½ cents per ton rate and that there would be no adverse change in the taxpayer's balance

sheet and no change in the capital structure during the option period. This option, however, was subject to the condition that the coal company would also exercise the second option whereby it acquired the right to purchase the coal land for $50.00 per acre or, in the alternative, to lease the property at a royalty of 10 cents per ton mined and sold, with a minimum royalty of $30,000 per year. On March 19, 1951, the coal company assigned its rights in these options to Ralph R. Lewis and Lewis, on or before July 1, 1951, notified the Jenkinses of his intent to exercise both options.

Thereafter the transactions occurred which gave rise to the present controversy. James Jenkins was dissatisfied with the terms of the option agreements and so notified Walter Biddle Saul, the attorney for Lewis. He was disturbed by the provision of the agreements that the stock was to be turned over to Lewis upon the payment of only $50,000 without any note or any security for the payment of the instalments, and with nothing in the agreements to prohibit the buyer from distributing the surplus of the corporation to himself even though the stock had not been paid for in full. Accordingly, the agreements were altered to meet these objections. A note was given for the purchase price of the stock and the stock was deposited as collateral for the payment of the note and it was agreed that there would be no increases in the salaries paid to the officers of the corporation and no dividends declared unless they were paid out of income earned after the sale of the stock. In addition, there was added a provision to the effect that the rental to be paid by the corporation for the locomotives should be fixed at 12½ cents instead of 7½ cents per ton as contemplated in the original agreement, and that the additional 5 cents per ton should be credited against any instalment payment due by Lewis on the purchase price of the stock of the railroad, and if no instalment was due then the additional 5 cents per ton should be credited against the minimum royalty due by Lewis under the lease of the coal

lands. Thereafter, in September 1951, and in each following month, the taxpayer rendered statements to members of the Jenkins family showing the number of tons shipped over the line and, in addition, the amount due them on account thereof and the portion attributable to the 5 cents per ton increase. For the years in question the following sums were thus received or accrued by the Jenkins family:

Taxable Year	Amount at 7½ cent rate	Amount at 5 cent rate
1951	$53,500.56	$19,982.40
1952	56,170.83	36,407.94
1953	45,965.20	29,590.43

The amounts represented by the 5 cents per ton factor during each of these years were credited against the instalment due from Lewis on his note in connection with the stock purchase.

The taxpayer on its federal income tax returns for these years deducted the full amount of the payments made at the 12½ cents rate as rent for the locomotives, but the Commissioner disallowed that portion of the payments which represented the additional 5 cents per ton. Consequently, the question to be decided is whether the additional sum of 5 cents per ton should be deducted from the taxpayer's income as an ordinary and necessary expense of operation of the railroad or should be considered as a payment by Lewis on account of the purchase price of the railroad company's stock.

The taxpayer contends that it is clearly entitled to deduct the entire 12½ cents per ton charge from its gross income under the provisions of § 23(a)(1)(A) of the Internal Revenue Code of 1939, which permits the deduction of all the ordinary and necessary expenses paid or incurred by a taxpayer in the taxable year in carrying on a trade or business. It is pointed out that the two locomotives constituted all the motive power available to the railroad and that it was conceded at the trial below that the rental of 12½

cents per ton of coal carried was a reasonable charge for this service. Hence it is said that the deductible character of the expenditure is clearly established.

The argument is not without force if attention is confined to the facts which it recites; but these constitute only a part of the picture. The modified agreements did indeed provide that the additional 5 cents per ton should be paid as rent for the use of the locomotives, and it was actually paid into the hands of Jenkins and his children in equal shares; * but it was stipulated that the payments should be credited upon the purchase price of the stock, and this was actually done. In other words, the additional sum was not applied by the Jenkinses to the payment of a debt due them by the railroad company in its corporate capacity but to the payment of a debt due them by Lewis in his individual capacity. In effect, a portion of the earnings of the railroad was pledged to the former stockholders of the taxpayer corporation so as to support Lewis's obligation to pay them for their holdings.

Accordingly, we think there was ample ground for the finding of the Tax Court that the increase in the rental did not constitute an ordinary and necessary expense of the taxpayer corporation but was rather a device for the payment of an obligation of Lewis. It is well settled that in matters of taxation substance rather than form prevails and that the taxability of a transaction is determined by its true nature rather than by the name which the parties may use in describing it. Thus, in *Beus v. Commissioner*, 9 Cir., 261 F. 2d 176 [58-2 USTC ¶ 9945], the deduction of so-called rental payments under a farm lease with option to buy was disallowed when it appeared that the payments

* The record is not entirely clear as to whether the locomotives belonged to Jenkins and his four children or solely to the children. The lease of June 14, 1946, was signed by the four children as lessors and by the father as president of the lessee corporation. The modifying agreement of September 24, 1951, on the other hand, named the five as the owners of the locomotives. It was stipulated by the parties, however, that the locomotives belonged to the four children, and yet the additional rental of 5 cents per ton was divided equally among the five. The only explanation offered was that the Jenkins family wanted it done that way.

were actually made as part of the purchase price of an interest in the property; in *Helvering v. Richmond F. & P. R. Co.*, 4 Cir., 90 F. 2d 271 [37-2 USTC ¶ 9353], payments of so-called "guaranteed dividends on guaranteed stock" by a corporation were held to be deductible since it was shown that the sums paid were in truth interest on a corporate debt, the court stating that the question was to be decided not by the names used by the parties to describe the transaction but by the nature and incidents of their rights in the stock; and in *Brush-Moore Newspapers, Inc. v. Commissioner*, 6 Cir., 95 F. 2d 900 [38-1 USTC ¶ 9247], deduction of payments by a corporation which were described as salary for services was denied when it was found that the payments were part of the purchase price of corporate stock. For like reasons the decision of the Tax Court in the pending case will be affirmed.

Affirmed.

Office Supreme Court, U.S.
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JAMES R. BROWNING, C

No. 884

In the Supreme Court of the United States

OCTOBER TERM, 1960

WEST VIRGINIA NORTHERN RAILROAD COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	3
Argument	6
Conclusion	8

CITATIONS

Cases:

Brush-Moore Newspapers, Inc. v. *Commissioner*, 95 F. 2d 900, certiorari denied, 305 U.S. 615 6

Comstock v. *Group of Investors*, 335 U.S. 211 .. 6

Statute:

Internal Revenue Code of 1939, Sec. 23(a) (26 U.S.C. 1952 ed., Sec. 23(a)) 2, 7

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In the Supreme Court of the United States

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No. 884

WEST VIRGINIA NORTHERN RAILROAD COMPANY,
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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 1a–9a)[1] are not officially reported. The opinion of the Court of Appeals (Pet. App. 13–17) is reported at 282 F. 2d 63.

JURISDICTION

The judgment of the Court of Appeals was entered on September 19, 1960. Its order denying taxpayer's petition for rehearing was entered January 10, 1961. The petition for a writ of certiorari was filed April 7,

[1] Record references are to the appendix to taxpayer's brief in the court below.

1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the two courts below were correct in finding that certain payments made by the taxpayer-corporation did not constitute ordinary and necessary rental expense of the corporation, but, rather, constituted payments for personal obligations of the corporation's sole stockholder, and, thus, were not deductible under Section 23(a)(1)(A) of the Internal Revenue Code of 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 23 [as amended by Sec. 121(a) of the Revenue Act of 1942, c. 619, 56 Stat. 819]. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * * *
>
> (26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The taxpayer-corporation is a railroad company which, during the tax years in question, operated eleven miles of track in West Virginia as a feeder of the Baltimore & Ohio Railroad Company. Up until 1951, the entire stock of the taxpayer was owned by James Jenkins and his four children, 600 shares by him and 100 shares each by the children. The Jenkins family also owned two Diesel locomotives which they had been leasing to the railroad at a rental of seven and one-half cents per freight-ton hauled. These locomotives were the sole motive power for the railroad. The family also owned 2,500 acres of coal land in Preston County, West Virginia. (Pet. App. 13.)

On December 30, 1950, the Jenkins family granted an option to the Preston Coal Company, exercisable on or before July 1, 1951, to purchase all of the taxpayer's stock for $500,000, of which $50,000 was payable in cash and the balance in fifteen annual installments. The option also provided that the purchaser was to take a twenty-five-year lease of the locomotives at the seven and one-half cents per ton rate and that there was to be no adverse change in the taxpayer's financial condition and no change in the capital structure during the option period. It was further provided that, in the event the coal company exercised the option, it would be required to exercise a second option to purchase the family's coal land at $50 per acre or, alternatively, to lease it at a royalty of ten cents per ton of coal mined and sold. The minimum royalty was to be $30,000 per year. (Pet. App. 13–14.)

On March 19, 1951, the coal company assigned its right in both options to Ralph R. Lewis, who, on or before July 1, 1951, notified the Jenkins family of his intent to exercise the options. (Pet. App. 14.)

Subsequently, James Jenkins notified Walter Biddle Saul, the attorney for Lewis, of his dissatisfaction with the terms of the options, particularly that the stock was to be turned over to Lewis upon receipt of the $50,000 down payment without any note or other security for the payment of the installments. (Pet. App. 14.) Among other changes, Saul agreed to give a note to secure payment of the balance of the purchase price after the initial $50,000, the stock to serve as collateral for the note. It was further agreed that on settlement the Jenkinses would lend Lewis $90,000 to cover (1) the initial payment on the stock, (2) a $20,000 initial payment on the coal property lease, Lewis having chosen to lease rather than purchase that property, and (3) $20,000 to meet the expenses of sale. The $90,000 was to be added to the $450,000 balance due on the stock purchase, making the total amount due on the note $540,000. (R. 4a.)

James Jenkins also asked that the locomotive rental be increased to twelve and one-half cents per freight ton and that the lease period be reduced from twenty-five to fifteen years, with the taxpayer having the right to terminate the lease by purchasing the locomotives outright for $387,500 in cash. Saul refused to agree to the latter demand, since the original agreement already established the rental rate at seven and one-half cents per ton and provided that the taxpayer's financial position should not be materially

worse at settlement than when the options were executed. Saul considered that the proposed rental increase would reduce the value of the taxpayer's stock and that therefore the price Lewis would have to pay for that stock would have to be reduced accordingly. The Jenkins family finally agreed. (R. 4a–5a.)

A provision was added to the agreement to the effect that the rental to be paid by the corporation for the locomotives should be fixed at twelve and one-half cents instead of seven and one-half cents per ton, as contemplated in the original agreement, and that the additional five cents per ton should be credited against any installment payment due by Lewis on the purchase price of the stock of the railroad, and, if no installment was due, then the additional five cents per ton should be credited against the minimum royalty due by Lewis under the lease of the coal lands. (Pet. App. 14–15.)

For the years in question the following sums were paid or accrued by the taxpayer under the amended rental agreement (Pet. App. 15):

Taxable year	Amount at 7½-cent rate	Amount at 5-cent rate
1941	$53,500.86	$19,982.69
1942	56,170.83	35,407.94
1943	45,969.20	29,500.43

The amounts represented by the five cents per ton factor during each of these years were credited against the installment due from Lewis on his stock purchase note. (Pet. App. 15.)

On its income tax returns for the years in question, the taxpayer deducted the full amount of the pay-

ments made at the twelve and one-half cents rate as locomotive rent; the Commissioner disallowed the portion representing the additional five cents per ton. (Pet. App. 15.) The Tax Court sustained the Commissioner's determination on the ground that the questioned amounts were payments by the taxpayer in satisfaction of the personal obligations of Lewis on the stock purchase rather than ordinary and necessary rental expenses of the corporation. (R. 8a.) The Court of Appeals affirmed. (Pet. 16–17.)

ARGUMENT

The question presented is one of fact, and the evidence supports the determination of both courts below. These concurrent findings are final in the absence of a very exceptional showing of error. *Comstock* v. *Group of Investors*, 335 U.S. 211, 214. The case does not conflict with any prior decision of any court of appeals or of this Court, and there is no other reason for further review.

The factual question posed is whether certain payments made by the taxpayer-corporation were truly intended by the parties as rental on locomotives used in its railroad business or as payments against the personal obligation of the sole corporate stockholder on the purchase price of the stock. This Court has consistently declined to review questions of this type and has denied certiorari in a case in which an almost identical issue was involved. *Brush-Moore Newspapers, Inc.* v. *Commissioner*, 95 F. 2d 900 (C.A. 6th), certiorari denied, 305 U.S. 615.

1. The taxpayer rests its petition (Pet. 9) upon the contention that both the Tax Court and the Fourth Circuit have decided a federal question in conflict with the provision of Section 23(a)(1)(A) of the Internal Revenue Code of 1939, *supra*, p. 2, and thereby have misinterpreted the statute. The taxpayer further states (Pet. 10), however, that "[i]f the expenses of a taxpayer are *in fact* rentals, constituting ordinary and necessary business expenses, then the statute requires that they shall be allowed as deductions * * *." (Emphasis added.) By using the words "in fact", the taxpayer states the sole issue that was decided below. In passing upon that issue, the courts below had no occasion to pass on any question of statutory interpretation. The Tax Court pointed to the basis for its decision when it said (R. 7a), "The character of the payments in issue must be determined from the intentions of the parties as evidenced by the agreements between them." The purely factual nature of the question was also recognized by the Court of Appeals which, in affirming, declared that "there was ample ground for the finding of the Tax Court" and pointed out that the taxpayer's argument was without validity since it was confined to facts which "constitute only a part of the picture." (Pet. App. 16.)

2. There is ample evidence in the record to support the finding of both courts that the payments disallowed as deductions were not intended as rental on the locomotives but were rather a device for the payment of a personal obligation of taxpayer's sole stockholder.

(a) The stockholder, Lewis, categorically rejected the demand by the Jenkins family for the increased rental rate, insisting that any amount to be paid by the taxpayer to the Jenkinses in excess of the original seven and one-half cents per ton rate had to be applied to his obligation on the purchase price of the stock. He consented to call these amounts "rentals" but insisted that they be treated as something else. (See the Statement, *supra*, pp. 4–5.)

(b) The amended agreement further provided that, where no installment payment was due on the purchase price of the stock when the monthly "rental" payment became due, the amount of the latter attributable to the five-cent factor was to be applied against the minimum royalties due on the coal land lease. (See the Statement, *supra*, p. 5.) This circumstance refutes taxpayer's contention (Pet. 10) that the additional "rental" payments were intended only as a means of "measuring the price ultimately to be paid for the railroad."

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

October Term, 1960.

No. 884.

WEST VIRGINIA NORTHERN RAILROAD CO.

COMMISSIONER OF INTERNAL REVENUE.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

INDEX.

	Page
REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT	2
CONCLUSION	11
CERTIFICATE OF COUNSEL	12

CASES CITED.

	Page
Burton-Sutton Oil Company, Inc. v. Commissioner, (1946) 328 U. S. 25	7
Commissioner v. J. S. Abercrombie Co., (CCA-5, 1947) 162 F. (2d) 338	8
Kirby Petroleum Corporation v. Commissioner, (1946) 326 U. S. 599	7
Wilshire Holding Corporation v. Commissioner, (CCA-9, 1958) 262 F. (2d) 51	9

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1960.

No. 884.

WEST VIRGINIA NORTHERN RAILROAD CO.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI.

Petitioner prays that this Court grant rehearing of its Order of May 22, 1961, denying the petition for writ of certiorari, — U. S. —, and that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit in the above-entitled case as prayed for in the petition for a writ of certiorari heretofore filed in this matter on April 7, 1961.

REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT.

1. At the time of this Court's order of May 22, 1961 the petitioner could have raised but did not raise an issue with respect to the application by the Court below of the doctrine of substance *versus* form. (A copy of the opinion of the United States Court of Appeals for the Fourth Circuit is printed in the Appendix to the original Petition for Writ of Certiorari. The Memorandum Findings of Fact and Opinion of the Tax Court of the United States is not officially reported but was filed by the Tax Court on October 28, 1959 as T. C. Memo 1959-204. (The unofficial citation is Par. 59,204 P-H Memo. T. C. or 18 TCM 975 (CCH).)

The single issue raised before the Tax Court and appealed to the United States Court of Appeals for the Fourth Circuit involved the deductibility of an amount of 5 cents per freight ton paid by the taxpayer to the Jenkins family ostensibly as part of the rent for locomotives under a lease agreement. The taxpayer argued that the total rental amount, 12½ cents per ton of freight, was deductible as an ordinary and necessary rental expense incurred in carrying on its trade or business of hauling coal. The Commissioner below did not contest the reasonableness of the rate of 12½ cents per ton; he contended that in substance 5 cents of this amount was paid by the taxpayer in satisfaction of an obligation of taxpayer's sole stockholder, Lewis. The Commissioner, therefore, asserted that the 5-cents-per-ton item did not constitute a deductible business expense for the corporation. The true character of the 5-cent-per-ton payments was the issue.

While the Tax Court did not expressly characterize this problem as "substance *versus* form" the Fourth Circuit Court of Appeals did. Granting that the doctrine is applicable, it is the *method* of applying that concept to the facts and the incongruous results reached below that are attacked in this petition for rehearing.

The essence of the petitioner's argument is that, in resolving this case under the doctrine of "substance *versus* form", neither court below took into proper consideration *all* of the surrounding circumstances and, as a result, neither placed a valid interpretation upon all of the facts; incompleteness and misinterpretation are the seeds of the error and unreality is the result.

The appellate court, and the Tax Court as well, appear to have overlooked the significance of the uncontroverted fact that the two options granted by the Jenkins family on December 30, 1950 to the Preston Coal Company, which are the same options assigned on March 19, 1951 to Lewis and later sought to be exercised by him, were from the outset improvident and deficient from the point of view of the Jenkins. These options, negotiated freely before Lewis had even entered the picture, dealt with the three major assets owned by the Jenkins family. One option related to the purchase of the Jenkins family stock in the taxpayer railroad company for $500,000.00 by July 1, 1951. The same option also provided for a 25-year extension of the existing lease of the two Diesel locomotives, (owned by the Jenkins family and the only source of power for the taxpayer) at .7½ cents per freight ton. It also provided that there were to be no adverse changes in the railroad company's balance sheet or capital structure during the option period. A condition of this first option was that the holder of the option must also exercise a second option if it exercised the first. The second option was for the acquisition of some 25,000 acres of coal lands at $50.00 per acre, owned by the Jenkins family, or, alternatively, leasing these properties at a royalty of 10 cents per ton of coal mined and sold with a minimum royalty of $30,000.00 per year.

While the Tax Court refused to recognize any interdependence or relationship between these two options, the substance of the arrangement would appear to be an attempt by the senior Jenkins to dispose of his family's holdings in coal lands, the railroad and the locomotives in one

package transaction. It is not credible that the two options would have been given to two different parties by the Jenkins family and, in fact, exercise of one was a condition precedent to exercise of the other.

No weight has been given to the fact that the option agreements, after they had been obtained by Lewis and he had indicated his intention of exercising them, were in effect repudiated by the Jenkins family as inadequate. Jenkins felt that the terms of the options failed to provide adequate security for his family and he therefore requested certain modifications before exercise of the options by Lewis. It is most important to recognize that it was at the instigation of Jenkins, and not Lewis, that various modifications were proposed in the pre-existing options even though Lewis was at that time under no legal obligation to make any concessions. Jenkins was concerned about the fact that under one option Lewis could immediately acquire the stock of the taxpayer company by a mere down payment, leaving nothing to evidence the unpaid balance except the option itself. He was also concerned about the possibility that the railroad company surplus could be distributed at any time thereafter by Lewis to himself as stockholder, even though the full price of the stock had not been paid to the Jenkins family.

After negotiation, Lewis was willing to make various concessions and modifications in the option agreements which Jenkins requested and this was done by various agreements on September 24, 1951. Notes were given covering the unpaid balance of $450,000.00, the price for the stock and the stock was deposited as collateral, Jenkins was given the right to name two directors to petitioner's Board for a ten-year period, the rental of the 2 Diesel locomotives was to be increased by 5 cents per ton, from 7½ cents to 12½ cents, and the term of the lease for the locomotives was to be reduced from 25 to 15 years, and the Company agreed "not to terminate the said contract during the period of the said lease, nor will the Railroad use any other motive power • • •." No dividends were to be paid by the com-

pany prior to the exercise of the options unless such amounts were credited as payments against the note indebtedness with an exception for a $20,000.00 dividend to be paid immediately to the Jenkins family. The railroad company also was not to increase salaries unless they could be paid from net earnings and no bonds superior to the stock held as collateral on the Lewis note were to be issued. The terms of the coal lands agreement were modified to apply to only 19,660.81 acres and a minimum royalty of $20,000.00.

Finally, and of considerable significance, is the fact that the Jenkins family would *lend Lewis* $90,000.00, $50,000.00 of which was to be the down payment on the stock, $20,000.00 to be an initial payment on the coal property lease, and $20,000.00 for expenses of sale. This amount added to the purchase price of the stock raised Lewis' note indebtedness to the Jenkins family to $540,000.00. The note carried interest at 2 percent per annum and annual payments for 15 years of some $34,000.00 were required after a $20,000.00 down payment 18 months after the date of execution.

During negotiations, Lewis' attorney had contended that the increased rental charge for the locomotives would, in effect, reduce the value of petitioner's stock by syphoning off additional corporate surplus and that it would violate the option requirement that the company's financial condition be the same at settlement as when the option was given. Therefore, he argued, the price of the stock should be reduced correspondingly. The Jenkins family had agreed to this.

As finally written, the lease for the Diesel engines was shortened from 25 to 15 years and the rate of payment therefor was increased from 7½ to 12½ cents per freight ton. The increase of 5 cents per freight ton was to be credited to "payments of the installments due on the [Lewis] note and the balance, if no installments be due, to the payment then due of the minimum royalties on the coal lands."

What fairly may be concluded to be the parties' intent in the light of these circumstances? One conclusion that appears to be immediately obvious is that the senior Jenkins was most desirous of providing something tantamount to a spendthrift arrangement whereby he could insure the steady flow of funds for himself and his four children over a period of 15 years through the efforts of an outsider. This appears to be his primary motivation and purpose. How else can the provision be explained that permitted the 5 cents per ton additional payments under the locomotive lease agreement to be applied first to the note, *but, alternatively, to the royalties on the coal lands?* It seems obvious, also, that the Jenkinses regarded the payments on the *note or royalties as related matter;* while the amounts paid could be deemed royalties, the fact that payments were to be applied *first* to the *note* has a significance which escaped the lower Courts. This factor, read against the indicated willingness of the Jenkins family to agree to a reduction in the stock purchase price should, if given proper weight, lead to the conclusion that basically all that was involved in the 5-cent factor was a device to pass money to the Jenkins family, from the company which had nothing to do with stock *purchase.* If the price of the stock was to be *reduced* below $500,000.00, the original price, then why should the 5 cents per ton be applied against the original $500,000.00 figure? This point has not been considered or answered by the lower Courts.

The fact that the *Jenkins family actually loaned Lewis the $90,000.00, to make this arrangement possible* has not been properly evaluated. This most unusual arrangement is incomprehensible and absurd on its face unless it is considered in perspective. It seems obvious that this transaction cannot be considered in isolation but must be regarded as but one step in an integrated transaction.

Against the background previously developed, its real significance must be that it was an inducement to Lewis to enter into the modified option agreements which had the

effect of reducing the value of the Railroad Company stock he was to receive; the corollary must be that the Jenkins family insisted on the 5-cent-per-ton increase in locomotive rentals motivated, at least partially, by a desire to recoup this amount from the Company. It may be coincidence, but the amount paid on the 5-cents-per-ton factor in the three years before the Court aggregates almost $86,000.00, an amount nearly equal to the $90,000.00 loaned to Lewis.

Coming now to the nub of this discussion, petitioner concludes that, realistically, the 5-cents-per-ton factor was designed and intended to pass to the Jenkins family income of the Railroad Company which they never had surrendered. Agreeing to a reduction in the sale price of the stock in exchange for increased locomotive rental, the 5-cents-per-ton device was a convenient way for the Jenkins family to measure the *reduction* of price for the stock in an otherwise indeterminate and variable situation. This being so, the amounts attributable to the 5-cent factor are not part of the stock purchase price. The Jenkins family had, in effect, retained ownership over this economic income. The fact that the Company had no alternative source of motive power, legally or actually, for the production of income except the Jenkins' locomotives is the unrecognized key to this situation.

This Court, in two related cases, has had occasion to pass upon the question of whether or not a transferor of property can retain a taxable economic interest in net profits produced by the asset leased. Such an issue arose in *Kirby Petroleum Corporation v. Commissioner,* (1946) 326 U. S. 599 and in *Burton-Sutton Oil Company, Inc. v. Commissioner,* (1946) 328 U. S. 25. While both of these cases dealt with mineral leases relating to oil and involved collateral problems such as depletion, they are also authority for the proposition that a taxpayer may reserve a taxable economic interest in property and its attributes despite an ostensible sale, lease or assignment. In *Burton-Sutton Oil Company, Inc. v. Commissioner, supra,* this Court stated:

> "Whether the instrument creating the rights is a lease, a sublease, or an assignment has not been deemed significant from the Federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place."

The same principle applies here.

The situation here may be analogized to that involved in the case of *Commissioner v. J. S. Abercrombie Co.*, (CCA-5, 1947) 162 F. (2d) 358. This was a case where assignors of certain mineral interests were held taxable upon the income from a retained 1/16th working interest in an oil and gas lease and, conversely, the assignees were held not to have received income consisting of this amount. Analogous "carried interests" are realistically involved here. Despite the verbiage and the form employed, and in light of the changes in the legal relationships of the parties just prior to exercise of the option, the Jenkins family had the purpose of retaining ownership of a portion of the operating profits of the assets (Railroad Company stock and locomotives) they had formerly owned until by application of these funds against the stock price of $500,000.00 the reduced price was reached at the end of the term of the lease.

The provisions they insisted upon for no change in balance sheet obligations, limitations on salaries, restrictions on dividends, the provision for the intervening $20,000.00 dividend and the other related factors discussed above all require this conclusion. Family security and cash flow were the aim. The proviso that the first preference would be to credit the 5-cent locomotive rental payments to the stock of Lewis was simply a recognition of the argument of Lewis' attorney that it worked a diminution in the value of the stock which was accordingly adjusted. While the amount of the reduction was not immediately measurable, the 5-cents-per-ton factor was a convenient way of measuring that amount. Petitioner cannot escape the conclusion

that the substance of all this was that the Jenkins family retained a definite economic interest in the profits of the taxpayer company which was to be measured by the 5-cent factor. That amount belonged to the Jenkins family and not to the company and should not be taxed to the latter.

2. The Courts below could have reached a still different ultimate result when considering the substance of these transactions.

One of the agreements entered into by the Jenkins family and Lewis on September 24, 1951 provided that there was a right "to purchase the two Diesel locomotives and cancel the locomotive contract upon the payment to the then owners of the contract for the locomotives the total sum of $387,500.00." Recall that what is in controversy here is the true nature of the "rental" payments (5 cents per ton of freight hauled) for the use of the locomotives. Also recall that simultaneously the term of the locomotive lease was *reduced* from 25 to 15 years and the amount of rental was *increased* from 7½ cents per ton to 12½ cents per ton. These suggest that in reality the so-called "rental" payments (to the extent of 5 cents per ton) could have been treated as *interest* on deferred installments of the purchase price of the locomotives. Such constructive interest would be deductible by the lessee-purchaser, the taxpayer.

The United States Court of Appeals for the Ninth Circuit has sanctioned such a "substance *versus* form" treatment where it felt required to apportion a part of the ostensible rent to interest on the deferred price under an option to purchase. See *Wilshire Holding Corporation v. Commissioner*, (CCA-9, 1958) 262 F. (2d) 51.

There is a certain persuasiveness to such a substance approach in the present case. It is clearly more logical to attribute a portion of the rental for locomotives to the purchase price of such locomotives under an option to purchase them than it is to attribute such payments to the purchase price of Lewis' stock (discussed in 1. above) as the Courts

below have done. The substance of such an approach supports an opposite result when compared with that reached in the Courts below.

The substance approach in 1. above would treat the questioned portion of the rental payment as taxable income retained by the Jenkins in reduction in the purchase price of the stock; the approach here would have the same net effect, namely, it would allow the deduction of the 5-cent factor as interest if not deemed rent.

3. This broad question and its implications are of major practical importance in the day-to-day administration of the Federal income tax laws. In nearly all instances a taxpayer's troubles with the taxing authorities commence with an audit by an Internal Revenue Agent. These Agents are rarely attorneys and most often have training in accounting. In auditing a taxpayer's return, taxable transactions occurring within the taxable year are examined minutely. Conventionally, some transactions are complex and this is but the logical outgrowth of the complexity of the taxing statutes themselves. In such transactions, as in more routine ones, the Internal Revenue Agent frequently feels called upon to review the form of the transactions as exemplified in various legal documents and papers. At this point, depending upon the ingenuity of the examining Agent, form may or may not be respected and here for the first time a tax case may take a turn in the direction of a "substance *versus* form" approach. This could, of course, take place at a higher administrative level in the Internal Revenue Service but the genesis is usually as described.

What rules guide the Revenue Agent, or anyone else for that matter, in departing from form and launching upon an intellectual exercise designed to ascertain the 'real facts" and the "reality" of the situation? It may be presumed that different minds grappling with the form and the reality of any given set of circumstances can conceivably reach different or indeed conflicting conclusions as to

the realities. The problem becomes more acute where there is absent any clear purpose of tax avoidance. Where the parties in a negotiation have, as a result of the give and take involved in bargaining, agreed upon a certain line of conduct thereafter reflected necessarily in a particular form, what guide lines must be followed to direct this form and arrive at a proper conclusion?

Today, the legal draftsman sees his work more and more frequently ignored. It may be scrutinized with a jaundiced eye and ultimately there may be determined a "substance" clearly not intended by either party. Without adequate guidance and direction, the pursuit of the elusive realities can, and in some circumstances does, produce an absurd result never envisaged. No taxpayer is beyond the threat of this possibility where zeal in tax collection places a premium upon ingenuity and no form, however well drawn, is beyond reach.

If form is to be set at naught in the field of Federal taxation, the process should be surrounded with appropriate safeguards and limitations. The present trend in the administration of the Federal tax laws as exemplified by the present case calls for a better solution to this vexing problem.

CONCLUSION.

For the reasons set forth above and in the petition for writ of certiorari it is respectfully urged that rehearing be granted and that, upo. such rehearing, a writ of certiorari issue to the United States Court of Appeals for the Fourth Circuit.

Respectfully submitted,

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Certificate of Counsel.

I hereby certify that the foregoing Petition for Rehearing is presented in good faith and not for delay and is restricted to the grounds specified above, which are other substantial grounds available to petitioner but not previously presented (under Rule 58, 2) which did not come to the attention of petitioner's counsel at the time of the preparation of the original petition for writ of certiorari.

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